

**The Internal Revenue Service Needs to Take  
Timely and Appropriate Closing Actions on  
Offers in Compromise**

**September 2002**

**Reference Number: 2002-30-181**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

September 25, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

*Michael R. Phillips*

FROM: Michael R. Phillips  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Internal Revenue Service Needs to  
Take Timely and Appropriate Closing Actions on Offers in  
Compromise (Audit # 200130010)

This report presents the results of our review of the Internal Revenue Service's (IRS) policies and procedures for closing offer in compromise (OIC) cases. The overall objective of this review was to determine the adequacy of OIC closing procedures to both ensure collection action is timely resumed on accounts when taxpayers' OICs are closed, and prevent unnecessary notices from being issued when taxpayers enter into installment agreements during the OIC process.

In summary, when the IRS rejects or returns OICs, or when taxpayers withdraw them, collection action is to promptly resume. However, the IRS had not resumed collection action at the time of our audit on approximately \$28 million due for the accounts of 191 taxpayers we reviewed, after their OICs were not accepted. Nationwide, we project that collection action had not yet been resumed at the time of our audit on the accounts of an additional 740 individual taxpayers with an estimated \$16 million due to the IRS. These delays were mainly due to a problem in the automated case closing process, which has subsequently been corrected, and in the manual processing of certain accounts not on the IRS Master File.<sup>1</sup> We recognize that not all of the balance due amounts will be collected because it is likely that some of the taxpayers are unable to fully pay; nevertheless, no collection activity was taking place on these accounts at the time of our review.

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<sup>1</sup> The Master File is the IRS' main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

The IRS could also improve both the accuracy of OIC processing and its monitoring of the status of accepted OICs. The appropriate closing transaction codes<sup>2</sup> were not always input to the Master File, and our review identified 16 taxpayers whose tax refunds and/or Tax Year (TY) 2000 rebates were erroneously offset to accounts relating to the accepted OICs, rather than being issued to them. The tax refunds and/or rebates were corrected for eight of the taxpayers, and we have referred the other eight to the Small Business/Self-Employed (SB/SE) Division for correction. Nationwide, we projected that an additional 705 taxpayers may have had tax refunds and/or TY 2000 rebates erroneously offset rather than being refunded to them, which have not yet been corrected.

Finally, in cases where the taxpayers decide to enter into an installment agreement rather than complete the OIC process, the IRS sometimes issues an unnecessary balance due notice. This may cause the taxpayer confusion and additional burden.

We recommended the Director, Compliance, SB/SE Division, identify all accounts erroneously shown as being open in OIC status and take appropriate action to return the accounts to the collection process. The Director should also review accounts relating to accepted OICs to identify and correct all cases where the taxpayer's refund or tax rebate was inappropriately offset. The Director should reemphasize the procedures for both closing OICs for accounts not on the Master File and ensuring the appropriate codes are input to taxpayers' accounts to prevent the erroneous offsets. In addition, the recently issued procedures for closing OICs when the taxpayers submit an installment agreement should be refined to prevent the issuance of unnecessary balance due notices. Changes should be made to the Automated Offer In Compromise (AOIC) System to generate a report whenever the status of an accepted OIC is not timely updated on the system, and to automatically suspend balance due notices in cases where the taxpayers are granted installment agreements.

Management's Response: The Commissioner, SB/SE Division, agreed that the recommendations in the report will enhance customer service. Among other things, the SB/SE Division has agreed to compare an extract of the Integrated Data Retrieval System (IDRS)<sup>3</sup> listing accounts in OIC status against the current AOIC System database and will correct accounts inappropriately in OIC status. They will identify accounts not on the Master File using a separate listing prepared from the AOIC System and manually compare to the account record to ensure employees have closed these accounts appropriately.

In addition, the AOIC System will generate a listing of all accepted cases that employees did not place in the appropriate monitoring status within 3 weeks of acceptance; accounts not having the appropriate transaction code on the IDRS will be corrected and erroneously held credits will be refunded, when appropriate. SB/SE

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<sup>2</sup> Transaction codes are used to identify transactions being processed to the IRS' computer systems and to maintain a history of actions posted to a taxpayer's account on the Master File.

<sup>3</sup> The IDRS is the IRS' computer system that employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Master File.

Division management will also issue instructions on how to create a report identifying these accounts, and will inform management of the time frames for running that report.

The SB/SE Division is engaged in a multi-year project to enhance many of the features of the AOIC System. They will explore the possibility of incorporating in the AOIC System a means to automatically generate a notification to the IDRS to suspend issuance of notices at the time the OIC is closed in cases where an installment agreement has been approved. The IRS has published Internal Revenue Manual (IRM) guidelines covering this, but will clarify the time needed to input transactions to the IDRS and address any additional information required in the next publication of the IRM.

While agreeing with our recommendations, SB/SE Division management disagreed with our conclusion about the revenue impact of delaying the resumption of collection activity. SB/SE Division management believes our report should reflect what they feel is a more realistic outcome measure by showing a probable range of additional revenue from the total available tax liabilities listed. Management's complete response to the draft report is included in Appendix V.

Office of Audit Comment: Although SB/SE Division management agreed with the recommendations and plans to take appropriate corrective action, they did not agree with the revenue impact of delaying the resumption of collection activity. SB/SE Division management stated that, for OICs that are not accepted, the IRS systemically analyzes and prioritizes the accounts and assigns a percentage of the highest priority cases for active collection but places the majority of accounts in an inventory queue to make the best use of its limited resources. While we agree that the IRS has limited resources and needs to prioritize work, we do not necessarily agree that rejected or withdrawn OIC cases should be analyzed in the same method as all other cases. While we did not perform a review of the IRS' new process for selecting work for assignment, we are concerned about this "systemic" selection process on rejected OICs, especially if the offer was rejected because the taxpayer had the ability to pay more than the original amount offered. SB/SE Division management performed an analysis of active collection cases closed during Fiscal Year 2001 to come up with the percentage of cases that would produce revenue and suggested we use that percentage to come up with what they viewed as a more realistic outcome measure. However, the cases we are referring to are not active collection cases but are, instead, rejected and withdrawn offers, so it would not be appropriate to apply that percentage to them.

Copies of this report are also being sent to the IRS officials who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Closing Actions on Offers in Compromise**

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## The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise

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### Background

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Internal Revenue Code § 7122<sup>1</sup> gives the Internal Revenue Service (IRS) the authority to compromise a taxpayer's tax liability. An offer in compromise (OIC) is a proposal by the taxpayer to settle unpaid tax accounts for less than the full amount of the assessed balance due. Taxpayers initiate an OIC by submitting an Offer in Compromise (Form 656), which is the official compromise proposal between the taxpayer and the IRS.

During Fiscal Year (FY) 2000, the IRS accepted 33,114 OICs proposed by taxpayers, rejected 10,517 OICs, and returned 27,249 OICs to taxpayers because they were not processable or complete. Taxpayers withdrew another 12,328 OICs.

When the IRS receives an OIC, it is entered on the Automated Offer in Compromise (AOIC) System, which is used to track and control OICs. When the specific tax accounts affected by the OIC are entered on the AOIC System, transaction codes<sup>2</sup> are systemically generated to the Integrated Data Retrieval System (IDRS)<sup>3</sup> and to the Master File<sup>4</sup> to indicate an OIC is being investigated.

The IRS is generally prohibited from taking collection action while an OIC is being considered and for 30 days after an OIC is rejected. In those cases where collection activity should be suspended, the AOIC System automatically changes the collection status of the accounts on the IDRS to prevent enforcement actions (e.g., levies on taxpayers' wages or seizures of their property) from being taken and to stop the issuance of balance due notices to taxpayers while the OIC is being processed.

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<sup>1</sup> Internal Revenue Code, 26 U.S.C. § 7122 (1998).

<sup>2</sup> Transaction codes are used to identify transactions being processed to the IRS' computer systems and to maintain a history of actions posted to a taxpayer's account on the Master File.

<sup>3</sup> The IDRS is the IRS' computer system that employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Master File.

<sup>4</sup> The Master File is the IRS' main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

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If the IRS rejects or returns the OIC, or the taxpayer withdraws it, IRS employees close the OIC on the AOIC System. At this time, the AOIC System should generate closing transaction codes to the IDRS and the Master File, and should automatically change the collection status back to active collection status to resume collection activity on the accounts.

On the other hand, if an OIC is accepted, the AOIC System automatically transfers it from the Collection field offices to the IRS compliance centers. IRS staff at these centers monitor the taxpayers' adherence to the terms of the OICs and their future compliance (i.e., the filing of necessary tax returns and payment of liabilities). The OICs are placed in various statuses to monitor their progress. When an OIC reaches the payment or refund monitoring status, usually in 3 to 4 weeks after being received at the compliance centers, the AOIC System generates a transaction code to the Master File and the IDRS to indicate that an OIC has been accepted. This transaction code prevents the Master File from automatically transferring other taxpayer payments into or out of the account.

Part of the OIC agreement is that the taxpayer agrees to allow the IRS to keep any tax refund for the year in which the OIC was accepted. However, the taxpayer is entitled to receive any subsequent tax year refunds. The taxpayer is also entitled to keep the Tax Year 2000 rebates provided for under the Economic Growth and Tax Relief Reconciliation Act of 2001,<sup>5</sup> if their OIC was accepted prior to January 1, 2001. The rebates can only be offset to outstanding balances due for OICs accepted in Calendar Year (CY) 2001.

Occasionally, during the processing of an OIC, taxpayers will decide instead to fully pay their account by making periodic payments, called an installment agreement. At the time of our review, there were no procedures for processing installment agreements in the OIC section of the Internal Revenue Manual (IRM). The IRM has recently been updated and now requires that when the investigating OIC

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<sup>5</sup> Pub. L. No. 107-16, 115 Stat. 38.

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employee approves an installment agreement, the taxpayer's accounts are to be updated to installment agreement status, which suspends the mailing of all notices except those for the installment agreement.

During a prior Treasury Inspector General for Tax Administration (TIGTA) audit,<sup>6</sup> we identified some instances where:

- Balance due accounts were not always timely returned to active collection status after the taxpayers' OICs were not accepted.
- Taxpayers received unnecessary balance due notices between the time their OICs were closed and their accounts were put into installment agreement status.

This current audit was conducted to determine the extent of those problems and what management can do to correct them. The review included a national data analysis of extracts from the AOIC System, the IDRS, and the Master File and a review of selected cases. We conducted the audit at the Dallas, Texas; Buffalo, New York; and Seattle, Washington Territory Offices; the Austin and Kansas City Compliance Centers; the Small Business/Self-Employed (SB/SE) Division Headquarters; and Information Technology Services in IRS Headquarters. We conducted the audit between March 2001 and February 2002 in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Our review identified 383 taxpayers, who owed the IRS about \$38 million, where collection action was not timely resumed on their accounts after their OICs were not accepted. In particular, collection activity on balance dues totaling approximately \$28 million for 191 of these taxpayers still had not been resumed at the time of our

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### **Collection Action on Taxpayers' Accounts Was Not Always Timely Resumed When Offers in Compromise Were Not Accepted**

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<sup>6</sup> Report titled, *The Internal Revenue Service Needs to Consistently Use Special Circumstances in the Offer in Compromise Program* (Reference Number 2001-30-096, dated May 2001).



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review. Collection action was resumed, but not timely, for the remaining 192 taxpayers.

Nationwide, we project that collection action was not timely resumed on an additional 886 individual taxpayers with an estimated \$21 million in Master File balance due accounts. In particular, we project that collection action still had not been resumed at the time of our review for 740 of these taxpayers with an estimated \$16 million in Master File balance due accounts.

We recognize that not all of the balance due amounts would have been collected because it is likely that some of the taxpayers would be unable to fully pay. However, no collection activity was taking place on these accounts, and will not resume until the correct status is entered to the IRS' computer system. Figure 1 summarizes these different groups of errors.

**Figure 1: Summary of Sample Case Reviews**

<u>Type of Case</u>	<u>Number of Taxpayers Reviewed</u>	<u>Total Errors Identified</u>	<u>Number Resumed, but Not Timely</u>	<u>Number Still Not Resumed</u>
<b>Master File</b>	765	326	172*	156
<b>Status 71<sup>7</sup> Over A Year</b>	237	12	2	10
<b>Not on Master File</b>	133	45	21**	25
<b>Totals</b>	1,135	383	195	191

*Source: TIGTA analysis of cases in our review from Master File, Master File Cases in Status 71 Over a Year, and cases not on Master File.*

\* Two taxpayers had accounts where some collection action was not yet resumed and others where collection action was just not resumed timely.

\*\* One taxpayer had accounts where some collection action was not yet resumed and others where collection action was just not resumed timely.

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<sup>7</sup> Status 71 indicates that the taxpayer's Master File account is in OIC status.

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Studies have shown that the sooner collection action is initiated, the better the collection results will be. Delaying the return of accounts such as these to collection status increases the risk that fewer, or no, dollars will ultimately be collected. In addition, this hinders the SB/SE Division's Compliance function from meeting its mission of increasing overall compliance and the fairness of compliance programs.

To determine the extent of the OIC accounts not being properly closed, we reviewed:

- Recently closed OIC accounts shown as not being accepted on the AOIC System, but where the AOIC System did not generate a closing transaction code.
- Accounts that were in OIC status on the IDRS for longer than 1 year.
- OIC accounts that were not on the Master File.

### **Recently closed OIC accounts with no closing transaction codes on the AOIC System**

We reviewed 763 OICs, filed to compromise the tax liabilities of 765 taxpayers, which were closed as not accepted on the AOIC System between May 1 and September 30, 2000, and where the AOIC System did not contain a closing transaction code. Without a closing transaction code on the AOIC System, the IDRS may not have been properly updated with the closing information to resume collection action. Our review of the closing actions for these 765 taxpayers identified the following specific problems.

As shown in Figure 1, 326 taxpayers did not have collection action timely resumed on all their tax accounts at the time of our review. Collection action did not resume for 1 to 18 months (averaging 10 months) after the OICs were closed. Balances due on these accounts totaled about \$19 million. In particular, collection activity on balances due totaling over \$10 million still had not been resumed at the time of our review, an average of 15 months after the OICs were closed, for 156 of these taxpayers. Collection activity was resumed, but not timely, on 172 taxpayers (2 taxpayers had accounts

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where some collection action was not yet resumed while other collection action had been resumed, but not timely).

Not reversing the open OIC transaction codes on the Master File also prevents credit balances on the offer tax periods from offsetting to balance due accounts after the offer is closed as not accepted. In fact, 15 taxpayers had \$7,091 in credit balances that had not been allowed to offset against balance due accounts for an average of 15 months since the OICs were closed.

We identified 35 taxpayers that had accounts with a \$0 balance that were still in open OIC status on the IDRS for an average of 15 months after the OIC was closed. While additional collection action is not needed on these tax accounts, they remain open on the IDRS, causing Management Information System reports to improperly reflect the current status of OIC accounts.

The main reason these accounts were not timely returned to collection activity was an AOIC System computer program problem that prevented the AOIC System from generating the closing transaction codes. We discussed the programming problem with the main computer programmer for the AOIC System, who advised us that the program for generating the transaction codes was changed in October 2000, was tested, and is now properly working.

While the IRS took prompt action to prevent future problems, the existing ones we identified were not corrected. We were advised that in late CY 2000, the SB/SE Division was notified of this computer program problem and was provided with the same computer extract of the 765 taxpayers we received. However, no action has been taken to identify the accounts still erroneously in OIC status and to resume collection action on them.

### **Accounts in OIC status over a year**

To determine the extent of the problem with delays in resuming collection activity on accounts on the Master File, we reviewed a statistical sample of 237 of 21,148 individual taxpayers whose Master File tax accounts were in OIC status for over a year. We identified 12 taxpayers, with balances due totaling about \$284,000, where collection

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action was not timely resumed. At the time of our review, collection action had not been resumed for 3 to 37 months (averaging 16 months) after the OIC was not accepted. Nationwide, we project that collection action was not timely resumed for an additional 886 individual taxpayers<sup>8</sup> with account balances of an estimated \$21 million. In particular, collection activity for 10 of the 12 taxpayers with balances due totaling about \$215,000 still had not been resumed at the time of our review, an average of 17 months after the OIC was closed. As a result, we project that nationwide, collection activity had not yet been resumed on tax accounts for an additional 740 taxpayers<sup>9</sup> with account balances of an estimated \$16 million. Collection action was resumed, but not timely, on the remaining two taxpayers.

The AOIC System computer programming problem discussed earlier accounted for 33 percent of the non-accepted OIC accounts not being timely returned to collection activity. Although a computer programming change corrected the problem, numerous OICs opened before the October 2000 programming change still require manual intervention to reverse the erroneous OIC status and return the accounts to the collection stream. In another 17 percent of the cases, the accounts were not on the IDRS and the closing actions needed to be manually input, which is discussed in the following section.

### **OIC accounts not on the Master File**

Certain accounts are not on the Master File. These primarily consist of joint (husband and wife) accounts that were originally on the Master File but where an action was taken that affects only one spouse (such as the filing of an OIC by one spouse). We reviewed all OICs filed by 133 taxpayers that were closed as not accepted during FY 2000 and where the taxpayers' accounts were not on the Master File.

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<sup>8</sup> Our projection is based on a statistical sample with a 95 percent confidence level and an accuracy of plus or minus 3 percent.

<sup>9</sup> Our projection is based on a statistical sample with a 95 percent confidence level and an accuracy of plus or minus 3 percent.

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We determined that collection action had not been timely resumed, as of the time of our review, for 45 of the 133 taxpayers. Collection action did not resume for 1 to 16 months (averaging 7 months) after the OICs were closed. Balances due on these accounts totaled about \$19 million. In particular, for 25 of these taxpayers, collection activity on balance due accounts totaling over \$17 million still had not been resumed at the time of our review, an average of 10 months after the OICs were closed. Collection activity was resumed, but not timely, on 21 taxpayers (1 taxpayer had accounts where some collection action was not yet resumed and other collection action was not resumed timely).

The AOIC System cannot automatically generate transaction codes to tax accounts that are not on either the Master File or the IDRS. The transaction codes for these types of accounts must be manually input. The AOIC System generates a transaction listing for the accounts not on the Master File, along with transactions that could not post due to some other type of error. The transaction lists stay on the AOIC System for only 14 days, and the offices working the OICs must resolve these errors manually.

We could not determine if the field offices were attempting to input the transaction codes and manually change the collection status on the accounts not on the Master File, or if they were relying on the AOIC System to update the accounts and then be notified of the input errors via the transaction listings. However, discussions with personnel in two of three offices during our 2001 audit showed the transaction lists were not always being reviewed and the errors resolved.

### **Recommendations**

The Director, Compliance, SB/SE Division, should:

1. Identify all the accounts, on the Master File and not on the Master File, still erroneously in OIC status and take action to return them to the appropriate collection status.

Management's Response: SB/SE Division management agreed with our recommendation and will compare an extract of the IDRS listing accounts in OIC status against

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the current AOIC System database. They will correct, on IDRS, accounts inappropriately in OIC status. For the accounts not on the Master File, they will use a separate listing prepared from the AOIC database and manually compare to the account record to ensure employees have closed these accounts appropriately.

Office of Audit Comment: Although SB/SE Division management agreed with the report's recommendations and plans to take appropriate corrective action, they do not agree with the revenue impact of delaying the resumption of collection activity. SB/SE Division management stated that, for OICs that are not accepted, the IRS systemically analyzes and prioritizes the accounts and assigns a percentage of the highest priority cases for active collection but places the majority of accounts in an inventory queue to make the best use of its limited resources. While we agree that the IRS has limited resources and needs to prioritize work, we do not necessarily agree that rejected or withdrawn OIC cases should be systemically analyzed in the same method as all other cases. While we did not perform a review of the IRS' new process for selecting work for assignment, we are concerned about this "systemic" selection process on rejected OICs, especially if the offer was rejected because the taxpayer had the ability to pay more than the original amount offered. SB/SE Division management performed an analysis of active collection cases closed during FY 2001 to come up with the percentage of cases that would produce revenue and suggested we use that percentage to come up with a more realistic outcome measure. However, the cases we are referring to are not active collection cases but are, instead, rejected and withdrawn offers, so it would not be appropriate to apply that percentage to them.

2. Re-emphasize the requirement to manually input the appropriate OIC codes on the accounts not on the Master File and reinforce the requirement to work the transaction listings that are generated daily by the AOIC System.

Management's Response: SB/SE Division management agreed with the recommendation and will send a

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### **Tax Refunds and Tax Year 2000 Tax Rebates Have Been Inappropriately Offset**

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memorandum to all employees working in the OIC Program informing them of the correct procedures when closing these types of cases and will incorporate the procedural information into the IRM.

Our review of a statistical sample of 237 accounts in OIC status over a year identified 63 taxpayers whose OICs had been closed as accepted. Accepted OICs are normally placed in various statuses on the AOIC System to monitor their progress. When an OIC reaches the payment or refund monitoring status, usually within 3 to 4 weeks of receipt at the compliance centers, the AOIC System automatically generates a transaction code to the taxpayer's Master File account to indicate that an OIC has been accepted. This transaction code also prevents the systemic transferring of credits into or out of tax accounts covered by the OIC.

This applicable transaction code was properly generated for 12 of the 63 accepted OICs, generated late for 19 OICs, and not generated for all the tax accounts relating to the remaining 32 OICs. IRS staff did not properly update the AOIC System to monitoring status to generate the transaction code in 18 of these 32 OICs. While the status was updated in the other 14 OICs, we could not determine the reason the transaction code was not generated.

As a result of not generating the appropriate transaction codes, 5 tax refunds totaling \$6,803 and 15 tax rebates totaling \$7,020 for 16 taxpayers were inappropriately applied to outstanding liabilities after their OICs had been accepted, rather than being issued to the taxpayers. While the misapplication of the tax refunds and/or rebates was subsequently corrected for eight of these taxpayers, not generating the appropriate transaction code caused a delay in the taxpayers receiving them.<sup>10</sup>

Based on our statistical sample, we project that an additional 1,411 taxpayers<sup>11</sup> nationwide had a tax refund/rebate

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<sup>10</sup> We referred the eight taxpayers whose refunds or rebates had not been corrected at the time of our review to the SB/SE Division for corrective action.

<sup>11</sup> Our projection is based on a statistical sample with a 95 percent confidence level and an accuracy of plus or minus 3 percent.

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inappropriately offset to tax accounts covered by an OIC because the appropriate transaction code was not generated. Of these, we project an additional 705 taxpayers did not have their refund or rebate properly returned to them at the time of our review and are still not corrected.

### **Recommendations**

The Director, Compliance, SB/SE Division, should:

3. Re-emphasize procedures for timely updating status information on accepted OICs on the AOIC System to ensure the appropriate transaction codes are generated to prevent inappropriate tax refund and/or tax rebate offsets.

Management's Response: SB/SE Division management agreed with the recommendation and will issue a memorandum on the importance of inputting the appropriate transaction codes on accepted OICs within the prescribed time frames and the consequences of untimely action.

4. Identify all accepted OICs that have not been updated to the appropriate monitoring status within a certain period of time after the OIC was accepted and review these to determine if the appropriate transaction codes have been input and if the taxpayers' refunds and/or rebates have been erroneously offset. When appropriate, issue refunds and rebates to these taxpayers.

Management's Response: SB/SE Division management agreed with our recommendation. They will have the AOIC System generate a listing of all accepted cases that employees did not place in the appropriate monitoring status within 3 weeks of acceptance and correct accounts that do not have the appropriate transaction codes on the IDRS. They will refund erroneously held credits, when appropriate.

5. Implement procedures for the AOIC System to periodically generate a report identifying accepted OICs when they have not been updated to the appropriate monitoring status within 3 months after the OIC was accepted. These reports can be used to ensure the appropriate transaction codes are input.



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### **Unnecessary Balance Due Notices Were Being Sent to Taxpayers Who Entered Into Installment Agreements During the Offer in Compromise Process**

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Management's Response: SB/SE Division management agreed with the recommendation and will issue instructions on how to create a report identifying these accounts, and will also inform management of the timeframes for running that report.

Occasionally during the processing of OICs, taxpayers will decide to enter into an installment agreement to full pay their accounts rather than complete the OIC process. When the IRS grants an installment agreement, the taxpayers' accounts should be updated to installment agreement status, thereby suspending the mailing of all notices to the taxpayers except those for the installment agreement.

We obtained AOIC System data for 21,160 taxpayers whose OICs were rejected or withdrawn during FY 2000. Our analysis of the Master File for these taxpayers identified 2,215 taxpayers (2,148 individual taxpayers and 67 business taxpayers) whose accounts were updated to installment agreement status within 90 days of the OIC being closed, indicating the installment agreement may have been a result of the OIC process. A balance due notice was sent to 1,661 (1,604 individuals and 57 businesses) of the 2,215 taxpayers (75 percent) between the time the OIC was closed and the accounts went into installment agreement status.

During the normal closing action for a non-accepted OIC, the AOIC System generates a closing pending transaction code to the IDRS. During the weekend following the AOIC System closure, the IDRS recognizes the OIC is closed and automatically generates a balance due notice. The IDRS can be notified to interrupt, delay or skip routine notices, but this notification must be made before the weekend following the AOIC System closure. These balance due notices may cause the taxpayers confusion and additional burden.

At the time of our review, the IRS had not established any procedures to cover the closing of OICs where the taxpayer requests an installment agreement. Although new procedures were recently issued calling for the suspension of these notices while the installment agreement is being

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processed, they do not require that the IDRS be notified to suspend notices the same week the OIC is closed.

### **Recommendations**

The Director, Compliance, SB/SE Division, should:

6. Determine the feasibility of programming the AOIC System to automatically generate the notification to the IDRS to suspend the issuance of notices at the time the OIC is closed in cases where the taxpayer has an approved installment agreement.

Management's Response: SB/SE Division management agreed with the recommendation and will explore the feasibility of incorporating this function into the AOIC System during their current multi-year project to enhance many of its features. However, they have currently scheduled replacement of the AOIC System and many other systems by a new Filing and Payment System, so this enhancement may not occur until that system is in place and fully functional.

7. Revise the current IRM procedures, until the programming in Recommendation 6 is completed, to require that the IDRS be notified to suspend notices within the same week the OIC is closed. All appropriate individuals should be made aware of this requirement while waiting for any change to be made to the AOIC System.

Management's Response: SB/SE Division management agreed with this recommendation. They stated they have published IRM guidelines covering this situation but will clarify the time needed to input transactions to the IDRS and address any additional information required in the next publication of the IRM.

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### **Appendix I**

#### **Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine the adequacy of offer in compromise (OIC) closing procedures to both ensure collection action is timely resumed on accounts when taxpayers' OICs are closed, and prevent unnecessary notices from being issued when taxpayers enter into installment agreements during the OIC process.

- I. Determined if collection action was timely resumed on taxpayers' accounts when their OICs were closed.
  - A. Obtained a computer download of all 763 Master File<sup>1</sup> OICs filed by 765 taxpayers and closed as not accepted on the Automated OIC (AOIC)<sup>2</sup> System between May 1, 2000, and September 30, 2000, where the AOIC System did not contain an OIC closing transaction code.<sup>3</sup>
  - B. Obtained a computer download from the AOIC System of all 135 OICs filed by 133 taxpayers, where the related accounts were not on the Master File and closed as rejected, withdrawn or returned during Fiscal Year (FY) 2000.
  - C. Obtained a computer extract from the Integrated Data Retrieval System (IDRS)<sup>4</sup> of all 80,144 accounts for 21,148 taxpayers that had been in OIC status for at least 1 year as of July 3, 2001. We selected a statistical sample of 243 taxpayers, based on a confidence level of 95 percent, with a precision level of plus or minus 5 percent, and an estimated error rate of 20 percent. After we reviewed the 237 cases (6 cases were not on the AOIC System and thus could not be reviewed), it was determined the actual error rate was 4 percent, so we recomputed that the final precision level is plus or minus 3 percent based on the revised error rate.
  - D. Reviewed the accounts from steps A, B, and C above of 1,135 taxpayers (6 taxpayers selected in step C were not on the AOIC System and thus not reviewed) to determine if the accounts were timely returned to collection status after the OICs were closed. If collection action was not timely resumed, we determined the number of months

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<sup>1</sup> The Master File is the Internal Revenue Service's (IRS) main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

<sup>2</sup> The AOIC System is the IRS' database used to monitor OIC case processing and was designed to control, track, and monitor OICs.

<sup>3</sup> Transaction codes are used to identify transactions being processed to the IRS' computer systems and to maintain a history of actions posted to a taxpayer's account on the Master File.

<sup>4</sup> The IDRS is the IRS' computer system that employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Master File.

## **The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise**

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- during which collection action was not timely resumed, and the balances due for those accounts.
- E. Reviewed the accounts relating to all 63 taxpayers identified in step C whose OICs were accepted to determine if the closing transaction code was properly input to the accounts to prevent the offset of the taxpayers' refunds and/or Tax Year 2000 tax rebates.
  - F. Interviewed employees in the Dallas, Texas; Buffalo, New York; and Seattle, Washington, Territory Offices; the Austin and Kansas City Submission Processing Centers; and the National Headquarters to determine the process for getting cases back in the collection stream after the offer is not accepted.
- II. Determined if taxpayers who requested installment agreements during the processing of their OICs were issued unnecessary balance due notices between the time their OICs were closed and their accounts were placed in installment agreement status.
- A. Received a download of all 21,160 offers rejected or withdrawn in FY 2000 from the AOIC System. We then analyzed the Master File data for the 21,160 taxpayers and identified 2,215 taxpayers whose accounts were placed in installment agreement status within 90 days after their OICs were closed.
  - B. Analyzed Master File data for the 2,215 taxpayers identified in step A, to determine if balance due notices were sent to the taxpayers between the time their OICs were closed and their accounts went into installment agreement status.
  - C. Determined what the procedures were for closing OICs in cases where the taxpayer requested an installment agreement.

**The Internal Revenue Service Needs to Take Timely and Appropriate  
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**Appendix II**

**Major Contributors to This Report**

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)

Parker F. Pearson, Director

Amy L. Coleman, Audit Manager

Timothy A. Chriest, Senior Auditor

James D. Dorrell, Senior Auditor

Lynn A. Rudolph, Auditor

**The Internal Revenue Service Needs to Take Timely and Appropriate  
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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner, Small Business/Self-Employed Division S  
Director, Compliance, Small Business/Self-Employed Division S:C  
Director, Filing and Payment Compliance, Small Business/Self-Employed Division S:C:CP:FP  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
Office of Management Controls N:CFO:F:M  
Audit Liaison:  
    Commissioner, Small Business/Self-Employed Division S:C:CP:I

## **The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise**

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### **Appendix IV**

#### **Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$10,302,915 on 156 taxpayers and 595 tax accounts on the Master File<sup>1</sup> where the Automated Offer in Compromise (AOIC)<sup>2</sup> System did not contain a closing transaction code<sup>3</sup> and the accounts are still in OIC status. While we recognize that not all of the balance due amounts will be collected because it is likely that some of the taxpayers would be unable to fully pay, no collection activity was taking place on these accounts at the time of our review (see page 3).

##### Methodology Used to Measure the Reported Benefit:

We conducted a 100 percent review of 2,772 tax accounts for 765 taxpayers that were on the Master File and were closed on the AOIC System without a closing transaction code to determine the amount of revenue that could be lost due to delays in resuming collection activity.

##### Type and Value of Outcome Measure:

- Increased Revenue – Potential; an estimate of \$16,121,782 million on 750 taxpayers that are still in OIC status and where the accounts have been in OIC status on the Integrated Data Retrieval System (IDRS)<sup>4</sup> for over a year; however, the OICs were closed as not accepted on the AOIC System. These 750 taxpayers are additional taxpayers beyond those identified in the first outcome measure. While we recognize that not all of the balance due amounts will be collected because it is likely that some of the taxpayers would be unable to fully pay, no collection activity was taking place on these accounts at the time of our review (see page 3).

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<sup>1</sup> The Master File is the Internal Revenue Service's (IRS) main computer system that stores various types of taxpayer account information, including individual, business, and employee plans and exempt organizations data.

<sup>2</sup> The AOIC System is the IRS' database used to monitor OIC case processing and was designed to control, track, and monitor OICs.

<sup>3</sup> Transaction codes are used to identify transactions being processed to the IRS' computer systems and to maintain a history of actions posted to a taxpayer's account on the Master File.

<sup>4</sup> The IDRS is the IRS' computer system that employees use to retrieve and update stored information; it works in conjunction with taxpayers' account records on the Master File.

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### Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 237<sup>5</sup> of 21,148 taxpayers whose tax accounts were open in OIC status on the IDRS for over 1 year, to determine the estimated amount of revenue that could be lost due to delays in resuming collection activity. We used the taxpayer's account balance on the IDRS at the time of our data extract to project the amount of revenue that could be lost. The sample was selected based on a confidence level of 95 percent, a precision level of plus or minus 5 percent, and an estimated error rate of 20 percent. After reviewing the 237 cases in our selected sample, we determined that the actual error rate was about 4 percent (10 out of 237 are still not reversed), which prompted us to have to change the precision level to plus or minus 3 percent.

Applying the actual error rate of 4.2194 percent (10 exception cases out of 237 reviewed) to the universe of 21,148 taxpayers resulted in a projection of 892 taxpayers still in OIC status at the time of our review. There are 142 taxpayers in the first outcome who are also in the universe of 21,148 taxpayers. Subtracting these 142 taxpayers from the projection of 892 results in a projection of 750 taxpayers (10 exceptions plus an additional 740).

The total balances due for the 10 exception taxpayers totaled \$214,957.11. To arrive at the potential increased revenue, we multiplied the average per taxpayer (\$21,495.71) times the projected 750 taxpayers, for a total of \$16,121,782.

### Type and Value of Outcome Measure:

- Increased Revenue – Potential; \$17,363,435 on 25 taxpayers and 57 tax accounts that were not on the Master File where the AOIC System showed the OICs were closed as not accepted. While we recognize that not all of the balance due amounts will be collected because it is likely that some of the taxpayers would be unable to fully pay, no collection activity was taking place on these accounts at the time of our review (see page 3).

### Methodology Used to Measure the Reported Benefit:

To determine the amount of revenue that could be lost due to delays in resuming collection activity, we conducted a 100 percent review of 308 tax accounts for 133 taxpayers that were not on the Master File and were closed on the AOIC System as not accepted during Fiscal Year (FY) 2000.

### Type and Value of Outcome Measure:

- Taxpayer Rights and Entitlements – Actual; 8 taxpayers' tax refunds and/or 2000 tax rebates inappropriately applied to tax accounts subject to an OIC.

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<sup>5</sup> These same 237 cases were used to perform the refund/rebate tests.



## **The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise**

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- Taxpayer Rights and Entitlements – Potential; projected an additional 705 taxpayers' tax refunds and/or 2000 tax rebates were inappropriately applied to tax accounts subject to an OIC and have not yet been corrected (see page 10).

### Methodology Used to Measure the Reported Benefit:

We reviewed a statistically valid sample of 237<sup>6</sup> of 21,148 taxpayers whose accounts were open in OIC status on the IDRS for over 1 year. We determined that OICs for 63 taxpayers were closed as accepted. We used the IDRS to determine if tax refunds or 2000 tax rebates were inappropriately offset against an account that was included on the accepted OIC. The sample was selected based on a confidence level of 95 percent, a precision level of plus or minus 5 percent, and an estimated error rate of 20 percent. After the review of the 237 cases in our selected sample, we determined that the actual error rate was about 3 percent for those still not corrected (8 out of 237), which prompted us to change the actual precision to plus or minus 3 percent.

Applying the actual error rate of 3.3755 percent to the universe of 21,148 taxpayers resulted in a projection of 713 taxpayers whose refund or rebate was incorrectly applied and not corrected at the time of our review (8 exception cases plus an additional 705 taxpayers).

### Type and Value of Outcome Measure:

- Taxpayer Burden – Actual; 1,661 of the 2,215 taxpayers whose accounts were updated to installment agreement status within 90 days of the OICs being closed received a balance due notice between the time their OICs were closed and the time the accounts went into installment agreement status (see page 12).

### Methodology Used to Measure the Reported Benefit:

We conducted a 100 percent review of the 2,215 taxpayers whose OICs were rejected or withdrawn in FY 2000 and whose accounts had an installment agreement within 90 days of the OIC closing. We analyzed the Master File for these accounts to identify those receiving a balance due notice between the time the OIC was closed and the time the account went into installment agreement status.

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<sup>6</sup> These same 237 cases were used to perform the delay in resumption of collection activity tests.

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### Appendix V

#### Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

SEP 6 2002

#### MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM:

Joseph G. Kehoe *David J. Kehoe*  
Commissioner, Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report - The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise (Audit # 200130010)

I reviewed your report and disagree with your conclusions about the revenue impact of delaying the resumption of collection activity. While I agree your recommendations will enhance customer service, I believe significant enhancement of revenue collection is doubtful.

Your report consistently lists the maximum revenue potential for non-accepted offer accounts returned for collection processing. Simultaneously, the report recognizes that collecting all of the balance due amounts is unlikely. To reflect a more realistic collection outcome your report should show a probable range of additional revenue from the total available tax liabilities you listed.

When we do not accept an offer in compromise and return it to collection status, we systemically analyze and prioritize those accounts. We assign a percentage of the highest priority accounts for active collection, while we place the majority of accounts in an inventory queue to make the best use of our limited resources.

An analysis of active collection cases closed during FY2001 shows:

Type of Disposition	Percentage of Total Dispositions
Full Payment	22.8%
Installment Agreement	17.6%
Currently Not Collectible	45.6%
Other Non-Payment Closures	14.0%

Even if all of the non-accepted offers cited in the report achieved a priority high enough to immediately go to active collection, historical data shows nearly 60% of these accounts would not yield revenue, and 17.6% would produce revenue over a protracted period.

## The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise

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Additionally, I agree with your statement, "Studies have shown that the sooner collection action is initiated, the better the collection results will be." We completed an analysis of 64,713 accounts in our offer inventory, in June 2002, which showed 73% of that inventory is compromised offers from tax periods over 3 years old. Because the majority of offer accounts are older assessments, it is likely that a similar percentage of non-accepted offers are equally as old. Because of this, an additional decrease in our success rate in collecting the tax cited in the report would be likely.

I am concerned that erroneous offset of refunds will result from our lack of timely action. We will use your recommendations to reemphasize the importance of timely actions and ensure accepted and non-accepted offers are in the appropriate status when we complete the offer examination. We will continue to work diligently at improving the quality of our offer processing.

### **RECOMMENDATION 1**

The Director, Compliance, Small Business/Self-Employed Division (SB/SE), should identify all the accounts, on the Master File and not on the Master File, still erroneously in OIC status and take action to return them to the appropriate collection status.

### **ASSESSMENT OF CAUSE**

We did not always return non-accepted offers to collection status. We identified and corrected a problem with the AOIC programming.

### **CORRECTIVE ACTION**

We will compare an extract of the IDRS listing accounts in OIC status against the current AOIC database. We will correct, on IDRS, accounts inappropriately in OIC status. We will identify accounts not on the Master File using a separate listing prepared from the AOIC database and manually compared to the account record to ensure employees have closed these accounts appropriately.

### **IMPLEMENTATION DATE**

July 1, 2003

### **RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

### **MONETARY BENEFIT**

Not measurable

### **CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

## The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise

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### **RECOMMENDATION 2**

The Director, Compliance, SB/SE Division, should re-emphasize the requirement to manually input the appropriate OIC codes on the accounts not on the Master File and reinforce the requirement to work the transaction listings that are generated daily by the AOIC System.

### **ASSESSMENT OF CAUSE**

Employees failed to follow established guidelines

### **CORRECTIVE ACTION**

SB/SE Compliance will send a memorandum to all employees working in the offer program informing them of the correct procedures when closing these types of cases. We will incorporate the procedural information into the IRM.

### **IMPLEMENTATION DATE**

January 1, 2003 - memorandum

July 1, 2003 – IRM

### **RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

### **MONETARY BENEFIT**

Not measurable

### **CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

### **RECOMMENDATION 3**

The Director, Compliance, SB/SE Division, should re-emphasize procedures for timely updating status information on accepted OICs on the AOIC System to ensure the appropriate transaction codes are generated to prevent inappropriate tax refund and/or tax rebate offsets.

### **ASSESSMENT OF CAUSE**

Employees failed to update AOIC with the proper monitoring status within prescribed timeframes.

### **CORRECTIVE ACTION**

We will re-emphasize, through memorandum, the importance of inputting the appropriate transaction codes on accepted OICs within prescribed timeframes and the consequences of untimely action.

### **IMPLEMENTATION DATE**

November 1, 2002

## The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise

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**RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

**MONETARY BENEFIT**

Not measurable

**CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

**RECOMMENDATION 4**

The Director, Compliance, SB/SE Division, should identify all accepted OICs that have not been updated to the appropriate monitoring status within a certain period of time after the OIC was accepted and review these to determine if the appropriate transaction codes have been input and if the taxpayers' refunds and/or rebates have been erroneously offset. When appropriate, issue refunds and rebates to these taxpayers.

**ASSESSMENT OF CAUSE**

Not applicable

**CORRECTIVE ACTION**

AOIC will generate a listing of all accepted cases that employees did not place in the appropriate monitoring status within 3 weeks of acceptance. We will correct accounts not having the appropriate transaction code on the IDRS. We will refund erroneously held credits when appropriate.

**IMPLEMENTATION DATE**

July 1, 2003

**RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

**MONETARY BENEFIT**

Not measurable

**CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

**RECOMMENDATION 5**

The Director, Compliance, SB/SE Division, should implement procedures for the AOIC System to periodically generate a report identifying accepted OICs when they have not been updated to the appropriate monitoring status within three months after the OIC was accepted. These reports can be used to ensure the appropriate transaction codes are input

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### **ASSESSMENT OF CAUSE**

Not applicable

### **CORRECTIVE ACTION**

We will distribute instructions for creating a local monitoring report and timeframes for running that report to local management for implementation.

### **IMPLEMENTATION DATE**

January 1, 2003

### **RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

### **MONETARY BENEFIT**

Not measurable

### **CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

### **RECOMMENDATION 6**

The Director, Compliance, SB/SE Division, should determine the feasibility of programming the AOIC System to automatically generate the notification to the IDRS to suspend the issuance of notices at the time the OIC is closed in cases where the taxpayer has an approved installment agreement.

### **ASSESSMENT OF CAUSE**

This situation applies to withdrawn offers only. While IRM guidance is in place, confusion exists on the proper cycling of transactions to the IDRS.

### **CORRECTIVE ACTION**

We are engaged in a multi-year project to enhance many of the features of the AOIC system. We will explore the possibility of incorporating this function into the AOIC during this period. Because we have scheduled replacement of the AOIC, and many other systems, by a new Filing and Payment System, this enhancement may not occur until that system is in place and fully functional.

### **IMPLEMENTATION DATE**

January 1, 2003

### **RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

### **MONETARY BENEFIT**

Not measurable

## **The Internal Revenue Service Needs to Take Timely and Appropriate Closing Actions on Offers in Compromise**

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### **CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

### **RECOMMENDATION 7**

The Director, Compliance, SB/SE Division, should revise the current IRM procedures, until the programming in recommendation 6 is completed, to require that the IDRS be notified to suspend notices within the same week the OIC is closed. All appropriate individuals should be made aware of this requirement while waiting for any change to be made to the AOIC System.

### **ASSESSMENT OF CAUSE**

This situation applies to withdrawn offers only. While IRM guidance is in place, confusion exists on the proper cycling of transactions to the IDRS.

### **CORRECTIVE ACTION**

We have published IRM guidelines covering this situation. We will clarify the time needed to input transactions to the IDRS and address any additional information required, in the next publication of the IRM.

### **IMPLEMENTATION DATE**

July 1, 2003

### **RESPONSIBLE OFFICIAL**

Director, Filing and Payment Compliance, SB/SE Division

### **MONETARY BENEFIT**

Not measurable

### **CORRECTIVE ACTION MONITORING PLAN**

The OIC Program Manager will inform the Director, Filing and Payment Compliance, SB/SE Division of any delays.

Please call Joseph R. Brimacombe, Director, Compliance Policy, SB/SE Division at (202) 283-2200 if you have any questions.